

Part D. Preferred Uses of Income

The Treasury Department proposals would curtail itemized deductions for certain personal expenditures, in order to broaden the tax base, simplify compliance and administration, and allow rates to be reduced. The deduction for State and local taxes would be phased out, and the charitable contribution deduction would be eliminated for nonitemizers and limited for itemizers. The deductions for medical expenses, casualty losses, and principal-residence mortgage interest would be left unchanged. Changes to the itemized deduction for interest expense deduction are described in Chapter 9.03 (indexing) and Chapter 16.01 (limit on interest deduction). The deduction for miscellaneous expenses would be replaced with an adjustment to income. (See Chapter 4.03).

REPEAL DEDUCTION OF STATE AND LOCAL TAXES

General Explanation

Chapter 3.17

Current Law

Individuals who itemize deductions are permitted to deduct certain State and local taxes without regard to whether they were incurred in carrying on a trade or business or income-producing activity. The following such taxes are deductible:

- o State and local real property taxes.
- o State and local personal property taxes. (In some States, payments for registration and licensing of an automobile are wholly or partially deductible as a personal property tax.)
- o State and local income taxes.
- o State and local general sales taxes.

Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes. Taxes incurred in carrying on a trade or business or which are attributable to property held for the production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-producing activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

Reasons for Change

The current deduction for State and local taxes in effect provides a Federal subsidy for the public services provided by State and local governments, such as public education, road construction and repair, and sanitary services. When taxpayers acquire similar services by private purchase (for example, when taxpayers pay for water or sewer services), no deduction is allowed for the expenditure. Allowing a deduction for State and local taxes simply permits taxpayers to finance personal consumption expenditures with pre-tax dollars.

Many of the benefits provided by State and local governments, such as police and fire protection, judicial and administrative services, and public welfare or relief, are not directly analagous to privately purchased goods or services. They nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities. Arguably, some individuals receive greater benefit from these services than others, but they are generally available on the same basis to all. Moreover, they are analagous to the services provided by the Federal government, and yet no deduction is allowed for the payment of Federal income taxes.

It is argued by some that State and local taxes should be deductible because they are not voluntarily paid. The argument is deficient in a number of respects. First, State and local taxes are voluntary in the sense that State and local taxpayers control their rates of taxation through the electoral process. Recent State and local tax reduction initiatives underline the importance of this process. Just as importantly, taxpayers are free to locate in the jurisdiction which provides the most amenable combination of public services and tax rates. Taxpayers have increasingly "voted with their feet" in recent years by moving to new localities to avoid high rates of taxation. Indeed, taxpayers have far greater control over the amount of State and local taxes they pay than over the level of Federal income taxes. Nevertheless, Federal income taxes are nondeductible.

The subsidy provided through the current deduction for State and local taxes is distributed in an uneven and unfair manner. Taxpayers in high-tax States receive disproportionate benefits, while those in low-tax States effectively subsidize the public service benefits received by taxpayers in neighboring States. Even within a single State or locality, the deduction of State and local taxes provides unequal benefits. Most State and local taxes are deductible only by taxpayers who itemize, and among itemizers, those with high incomes and high marginal tax rates receive a disproportionate benefit.

Finally, the deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. Repeal of the deduction is projected to generate \$33.8 billion in revenues for 1988. Unless those revenues are recovered, the rates of tax on nonexcluded income will remain at their current unnecessarily high levels.

Proposal

The itemized deduction for State and local income taxes and other taxes that are not incurred in carrying on a trade or business or income-producing activity would be phased out over a two-year period. For taxable years beginning on or after January 1, 1986, only 50 percent of such taxes would be deductible. For taxable years beginning on or after January 1, 1987, no portion of such taxes would be deductible. State and local taxes (other than income taxes) which

currently are deductible only by itemizers, but which are incurred in carrying on an income-producing activity, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible subject to a threshold. See Ch. 4.03.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986, subject to the transitional rules described above.

Analysis

State and local taxes are the cost paid by citizens for public services provided by State and local governments, such as public schools, roads, and police and fire protection. For the one-third of all families that itemize deductions, these public services are purchased with pre-tax dollars.

Table 1 shows the distribution of families that itemize deductions for State and local taxes. While one-third of all families itemized deductions in 1983, most high-income families itemized (95 percent of families with incomes over \$100,000) while there were relatively few itemizers among lower-income families. Two-thirds of the total deductions for State and local tax payments were claimed by families with economic incomes of \$50,000 or more. The benefits of the deduction are even further skewed toward high-income families because deductions are worth more to families with higher marginal tax rates.

Because income levels vary across the country, taxpayers in various States make differing use of itemized deductions and pay different marginal tax rates. That is, residents of high-income, high-tax States make more use of itemized deductions than do residents of low-income, low-tax States. Under current law, the Federal government underwrites a greater share of State and local government expenditures in high-income and high-tax States than in low-income and low-tax States. Table 2 shows the States ranked on the basis of per capita incomes and the percent of returns with itemized deductions.

The three most important sources of State and local tax revenue in the United States are the general sales tax, the personal income tax, and the property tax. There may be a tendency to believe that itemized deductions should be eliminated for some of these taxes, but retained for others. The degree of reliance on these three tax bases, however, varies widely from State to State, as shown in Table 3. For example, 97 percent of the revenue that New Hampshire derives from these three tax bases came from property taxes, while Louisiana relies primarily on sales taxes (69 percent) and Delaware on income taxes (73 percent). Allowing itemized deductions for some of these revenue

sources but not others would unfairly benefit the residents of the State policy decisions at the State and local level away from the nondeductible revenue source, just as current law discourages localities from using nondeductible fees and user charges.

Table 1
Distribution of Deductions for Taxes Paid
by Economic Income - 1983

| Family Economic Income | : | Number of Families (thousands) | : | Percent with State and Local Deduction | : | State and Local Taxes Deducted 1/ (\$millions) | : | Average Amount Deducted 2/ |
|------------------------------|---|--------------------------------------|---|--|---|---|---|----------------------------------|
| \$ 0 - 9,999 | | 337 | | 2 | | \$ 233 | | \$ 691 |
| 10,000 - 14,999 | | 516 | | 4 | | 465 | | 901 |
| 15,000 - 19,999 | | 1,009 | | 9 | | 1,009 | | 1,089 |
| 20,000 - 29,999 | | 3,894 | | 22 | | 5,307 | | 1,363 |
| 30,000 - 49,999 | | 10,820 | | 51 | | 22,012 | | 2,034 |
| 50,000 - 99,999 | | 11,298 | | 80 | | 36,408 | | 3,223 |
| 100,000 - 199,999 | | 1,793 | | 95 | | 12,150 | | 6,776 |
| 200,000 or more | | 426 | | 97 | | 9,090 | | 21,338 |
| Total | | 30,093 | | 33 | | \$ 86,762 | | \$ 2,883 |

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1/ Net of income tax refunds.

2/ For families tht itemize deductions.

Source: Treasury estimates.

Table 2

States Ranked by Deductible Taxes Per Capita - 1982

| State | Deductible Taxes Per Capita | Deductible Taxes as Percent of Income | Rank | Income Per Capita | Rank | Percent of Returns Itemizing | Rank |
|----------------------|--------------------------------|--|------|----------------------|------|------------------------------------|------|
| District of Columbia | \$ 1,583 | 10.7 | 3 | \$ 14,743 | 1 | 34.2% | 20 |
| New York | 1,422 | 11.7 | 1 | 12,204 | 10 | 43.9 | 4 |
| Wyoming | 1,375 | 11.3 | 2 | 12,222 | 9 | 31.4 | 31 |
| Hawaii | 1,122 | 9.7 | 4 | 11,590 | 16 | 34.4 | 17 |
| Massachusetts | 1,066 | 8.7 | 9 | 12,287 | 6 | 34.1 | 22 |
| California | 1,018 | 8.1 | 16 | 12,617 | 5 | 37.2 | 10 |
| Michigan | 1,000 | 9.3 | 5 | 10,751 | 27 | 40.9 | 7 |
| Maryland | 992 | 8.1 | 14 | 12,280 | 7 | 44.7 | 3 |
| Wisconsin | 987 | 9.2 | 7 | 10,774 | 26 | 36.8 | 11 |
| New Jersey | 948 | 7.2 | 26 | 13,164 | 4 | 35.1 | 15 |
| Rhode Island | 940 | 8.6 | 10 | 10,930 | 21 | 31.8 | 29 |
| Minnesota | 925 | 9.0 | 8 | 10,290 | 31 | 41.6 | 5 |
| Alaska | 925 | 5.5 | 45 | 16,854 | 2 | 30.2 | 33 |
| Connecticut | 917 | 6.6 | 35 | 13,939 | 3 | 33.8 | 24 |
| Colorado | 917 | 7.5 | 20 | 12,239 | 8 | 44.7 | 2 |
| Illinois | 899 | 7.5 | 21 | 12,027 | 11 | 33.8 | 25 |
| Iowa | 868 | 8.2 | 13 | 10,635 | 29 | 33.1 | 26 |
| Oregon | 845 | 8.3 | 12 | 10,148 | 32 | 39.7 | 9 |
| Washington | 827 | 7.1 | 27 | 11,694 | 15 | 36.1 | 12 |
| Kansas | 823 | 6.9 | 28 | 11,850 | 14 | 34.2 | 18 |
| Arizona | 812 | 8.1 | 15 | 10,053 | 34 | 39.8 | 8 |
| Nebraska | 799 | 7.3 | 22 | 10,886 | 24 | 35.4 | 14 |
| Utah | 797 | 9.2 | 6 | 8,693 | 47 | 45.0 | 1 |
| Maine | 785 | 8.5 | 11 | 9,264 | 41 | 17.9 | 50 |
| Vermont | 759 | 8.0 | 18 | 9,518 | 38 | 34.2 | 19 |
| Montana | 750 | 7.8 | 19 | 9,617 | 37 | 21.6 | 47 |
| Pennsylvania | 745 | 6.8 | 30 | 10,928 | 23 | 28.0 | 39 |
| Indiana | 734 | 7.3 | 23 | 10,019 | 35 | 28.5 | 37 |
| West Virginia | 718 | 8.0 | 17 | 8,966 | 46 | 17.7 | 51 |
| Virginia | 718 | 6.3 | 36 | 11,353 | 18 | 34.1 | 21 |
| Ohio | 718 | 6.7 | 33 | 10,659 | 28 | 28.5 | 38 |
| Georgia | 697 | 7.2 | 25 | 9,637 | 36 | 29.8 | 34 |
| South Dakota | 679 | 7.3 | 24 | 9,332 | 39 | 17.9 | 49 |
| Delaware | 676 | 5.7 | 44 | 11,912 | 13 | 41.2 | 6 |
| Nevada | 638 | 5.4 | 47 | 11,919 | 12 | 35.1 | 16 |
| Missouri | 638 | 6.1 | 38 | 10,403 | 30 | 32.7 | 27 |
| Oklahoma | 634 | 5.7 | 42 | 11,071 | 20 | 35.9 | 13 |
| Texas | 612 | 5.4 | 46 | 11,380 | 17 | 26.1 | 42 |
| North Carolina | 610 | 6.7 | 34 | 9,147 | 42 | 27.7 | 40 |
| Idaho | 609 | 6.8 | 32 | 9,012 | 45 | 32.1 | 28 |
| South Carolina | 598 | 6.9 | 29 | 8,613 | 49 | 31.0 | 32 |
| Louisiana | 581 | 5.8 | 41 | 10,065 | 33 | 24.7 | 43 |
| New Mexico | 576 | 6.2 | 37 | 9,285 | 40 | 29.7 | 35 |
| Florida | 571 | 5.2 | 49 | 10,929 | 22 | 26.8 | 41 |
| North Dakota | 570 | 5.2 | 48 | 10,866 | 25 | 23.5 | 45 |
| New Hampshire | 569 | 5.1 | 50 | 11,131 | 19 | 21.4 | 48 |
| Kentucky | 555 | 6.1 | 39 | 9,122 | 43 | 33.8 | 23 |
| Mississippi | 525 | 6.8 | 31 | 7,733 | 51 | 23.8 | 44 |
| Tennessee | 516 | 5.7 | 43 | 9,029 | 44 | 21.6 | 46 |
| Arkansas | 496 | 5.9 | 40 | 8,444 | 50 | 28.9 | 36 |
| Alabama | 443 | 5.1 | 51 | 8,684 | 48 | 31.8 | 30 |
| Total | \$ 835 | 7.5% | — | \$ 11,113 | — | 33.4% | — |

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1/ These represent 94% of the deductions for taxes paid in 1982.

Source: Treasury estimates and Advisory Commission on Intergovernmental Relations.

Table 3

Use of Different Deductible Taxes by States in 1982

Percent of Taxes that can be Itemized ^{1/}

| State | : Property : Taxes | : General Sales : Taxes | : Individual : Income Taxes |
|----------------|-----------------------|----------------------------|--------------------------------|
| Alabama | 19.8% | 50.7% | 29.5% |
| Alaska | 89.1 | 10.9 | 0 |
| Arizona | 38.7 | 42.4 | 18.9 |
| Arkansas | 31.6 | 37.4 | 31.0 |
| California | 33.1 | 37.3 | 29.6 |
| Colorado | 43.0 | 37.3 | 19.7 |
| Connecticut | 60.6 | 34.7 | 4.7 |
| D.C. | 34.0 | 24.8 | 41.2 |
| Delaware | 26.8 | 0 | 73.2 |
| Florida | 53.1 | 46.9 | 0 |
| Georgia | 35.3 | 34.6 | 30.1 |
| Hawaii | 22.8 | 51.8 | 25.5 |
| Idaho | 37.9 | 24.7 | 37.4 |
| Illinois | 47.2 | 31.1 | 21.7 |
| Indiana | 42.7 | 37.9 | 19.5 |
| Iowa | 50.5 | 20.8 | 28.7 |
| Kansas | 51.0 | 25.7 | 23.2 |
| Kentucky | 27.0 | 33.5 | 39.5 |
| Louisiana | 22.4 | 68.9 | 8.7 |
| Maine | 48.6 | 27.9 | 23.5 |
| Maryland | 33.9 | 18.9 | 47.2 |
| Massachusetts | 47.4 | 14.8 | 37.8 |
| Michigan | 53.1 | 20.2 | 26.7 |
| Minnesota | 36.5 | 23.0 | 40.5 |
| Mississippi | 30.5 | 57.1 | 12.4 |
| Missouri | 35.7 | 36.2 | 28.1 |
| Montana | 76.1 | 0 | 23.9 |
| Nebraska | 55.6 | 26.5 | 17.8 |
| Nevada | 33.0 | 67.0 | 0 |
| New Hampshire | 97.3 | 0 | 2.7 |
| New Jersey | 61.8 | 19.7 | 18.6 |
| New Mexico | 25.4 | 72.8 | 1.7 |
| New York | 40.2 | 23.3 | 36.5 |
| North Carolina | 33.0 | 27.4 | 39.6 |
| North Dakota | 52.2 | 38.5 | 9.3 |
| Ohio | 45.7 | 26.0 | 28.3 |
| Oklahoma | 26.2 | 42.0 | 31.8 |
| Oregon | 56.8 | 0 | 43.2 |
| Pennsylvania | 39.0 | 25.1 | 35.9 |
| Rhode Island | 54.0 | 22.1 | 23.9 |
| South Carolina | 32.6 | 33.8 | 33.6 |
| South Dakota | 56.8 | 32.2 | 0 |
| Tennessee | 37.2 | 60.8 | 1.9 |
| Texas | 55.7 | 44.3 | 0 |
| Utah | 33.5 | 39.2 | 27.3 |
| Vermont | 59.0 | 12.2 | 28.7 |
| Virginia | 40.6 | 22.7 | 36.7 |
| Washington | 40.8 | 59.2 | 0 |
| West Virginia | 22.2 | 55.8 | 22.0 |
| Wisconsin | 43.9 | 20.4 | 35.7 |
| Wyoming | 60.4 | 39.6 | 0 |
| U.S. Average | 42.5% | 31.4% | 26.2% |

Office of the Secretary of Treasury November 29, 1984
Office of Tax Analysis

^{1/} Certain other taxes can also be itemized deductions. These three major taxes accounted for 94 percent of total taxes itemized in 1982.

Source: Advisory Commission on Intergovernmental Relations,
Significant Features of Fiscal Federalism, 1982-83
Edition, Table 28.

IMPOSE FLOOR ON CHARITABLE DEDUCTIONS

General Explanation

Chapter 3.18

Current Law

Individuals and corporations are allowed a deduction for contributions to or for the benefit of religious, charitable, educational, and similar nonprofit organizations. Current law limits the allowable deduction to a specified percentage of the donor's income but does not set a threshold below which contributions may not be deducted.

Reasons for Change

It is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities. The expense of verification is out of proportion to the amounts involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions without risk.

Most individuals would contribute small amounts to charitable organizations without the incentive of an income tax deduction. Thus, the efficiency of the Federal subsidy to charitable organizations is very low with respect to small donations.

Proposal

Individuals and corporations would be allowed charitable contribution deductions only to the extent such contributions exceed two percent of the taxpayer's adjusted gross income (AGI).

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986. For contributions made in taxable years beginning after December 31, 1985, and before January 1, 1987, however, a one percent floor would apply in place of the two percent floor.

Analysis

Two percent of AGI is approximately the median charitable contribution deduction claimed by taxpayers who itemize deductions. In other words, one-half of all itemizers claim less than one percent of their AGI, while one-half claim more than that, as charitable contribution deductions. Thus, the proposal would disallow all of the charitable deductions of about one-half of all taxpayers who itemize.

Table 1 shows the distribution of charitable contributions by families. The first two columns (labeled Total Donors) refer to all contributions, whether itemized as deductions on tax returns or not. Of the 68 million families making donations, about 40 percent claim an itemized deduction for charitable contributions under current law, as shown in the next two columns, ranging from three percent in the lowest income class to 90 percent in the highest. Although itemizers account for only 40 percent of all donating families, they give almost 70 percent of total contributions.

By removing tax deductions for small charitable gifts, the proposal would simplify recordkeeping requirements for taxpayers and would eliminate the need for the Internal Revenue Service to spend resources verifying these small contributions.

The proposal would have some effect on charitable giving, but the impact is not expected to be significant. It is doubtful that the first dollars of giving, or the giving of those who give only modest amounts, are affected significantly by tax considerations. Rather, contributions also depend on factors such as financial ability to give, membership in charitable or philanthropic organizations and general donative desire. As potential giving becomes large relative to income, however, taxes are more likely to affect the actual level of donations. Under the proposal, the current incentive would be maintained for the most tax sensitive group -- taxpayers who give above-average amounts.

Table 1

Distribution of Total and Deductible
Charitable Contributions by Economic Income -- 1983 1/

| Family Economic Income | : Total Donors | | : Itemized Deductions | |
|---------------------------|-------------------------|---------------|----------------------------|--------------|
| | : (Includes non-filers) | | : -- Present Law <u>2/</u> | |
| | : Families | : All Contri- | : Families | : Deduc- |
| | (thousands) | (millions) | (thousands) | (millions) |
| \$ 0 - 9,999 | 5,349 | \$ 1,398 | 164 | \$ 190 |
| 10,000 - 14,999 | 7,891 | 2,054 | 380 | 264 |
| 15,000 - 19,999 | 8,159 | 2,394 | 743 | 415 |
| 20,000 - 29,999 | 12,814 | 5,230 | 3,075 | 1,902 |
| 30,000 - 49,999 | 17,892 | 10,108 | 9,603 | 6,757 |
| 50,000 - 99,999 | 12,992 | 13,164 | 10,633 | 11,116 |
| 100,000 - 199,999 | 1,819 | 4,715 | 1,729 | 4,484 |
| 200,000 or more | <u>424</u> | <u>6,628</u> | <u>411</u> | <u>6,593</u> |
| Total | 67,340 | \$ 45,691 | 26,738 | \$31,721 |

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1/ Source: Treasury estimates.

2/ Includes itemized returns only.

LIMIT CHARITABLE DEDUCTION FOR APPRECIATED PROPERTY

General Explanation

Chapter 3.19

Current Law

A taxpayer who makes a gift of appreciated property to charity generally does not realize income with respect to any appreciation in the property's value. (In the case of a sale of appreciated property to charity for less than its fair market value, the transaction is treated as in part a gift and in part a sale, and the taxpayer realizes income with respect to an allocable portion of the property's appreciation.) A taxpayer also does not realize a loss for tax purposes on a charitable donation of depreciated property. Any deductible loss with respect to such property will be realized, however, if the taxpayer sells the property and donates the proceeds to charity.

In general, current law allows a charitable contribution deduction for the fair market value of appreciated (or depreciated) property donated to charity. This general rule is subject to exceptions depending on the identity of the donee, the donee's use of the property and the character and holding period of the property in the hands of the donor. In the case of long-term capital gain property, if the donee's use of the property is unrelated to its exempt purpose or if the donation is to certain types of private foundations, the amount of the deduction is reduced by 40 percent (about 57 percent for a corporate donor) of the donor's unrealized long-term capital gain. Thus, a deduction is allowed for the entire adjusted basis of the property plus 60 percent of the appreciation (about 43 percent for a corporate donor). In the case of other appreciated property, the allowable deduction is reduced by the amount of ordinary income or short-term capital gain that the donor would have realized if the property had been sold for its fair market value.

Donors of most property with a value of more than \$5,000 must obtain an appraisal of the property from a qualified appraiser and must attach a summary of the appraisal to the tax return on which the deduction is claimed in order to obtain a deduction. Contributions of other property must be substantiated under regulations.

Reasons for Change

The current treatment of certain charitable gifts of appreciated property is unduly generous and in conflict with basic principles governing the measurement of income for tax purposes. In other circumstances where appreciated property is used to pay a deductible

expense, or where such property is the subject of a deductible loss, the deduction allowed may not exceed the taxpayer's adjusted basis plus any gain recognized. Thus, a taxpayer generally may not receive a tax deduction with respect to untaxed appreciation in property. The current tax treatment of certain charitable gifts departs from this principle by permitting the donor a deduction for the full value of the property, including the element of appreciation with respect to which the donor does not realize gain.

The generous tax treatment for certain gifts of appreciated property also creates an incentive for taxpayers to make gifts of such property rather than gifts of cash, even though in many instances charities would prefer to receive cash rather than property of equivalent value. A taxpayer in the 40 percent bracket making a gift of \$200 in cash receives a \$200 deduction. This translates to an \$80 savings in tax, which reduces the after-tax cost of the \$200 gift to \$120. The same taxpayer donating \$200 worth of property that is a capital asset held for the long-term capital gain holding period receives the same \$200 deduction and \$80 in tax savings. If, however, the donated property is appreciated property, the donor receives an additional tax savings by avoiding tax on the property's appreciation. Although the value of this tax savings depends on the amount of the property's appreciation and on when and how the donor otherwise would have disposed of the asset, its availability has proved to have a significant influence on the form of charitable donations.

Current law does limit the amount of the deduction for certain gifts of appreciated property, but these rules are only a partial response to the problem and require complicated inquiries concerning the donee's use of the property and the character of the property in the donor's hands. In addition, under current law it is necessary in almost all instances to value the donated property. This is a significant burden for taxpayers and for the Internal Revenue Service and leaves the system open to serious abuse through fraudulent overvaluations of contributed property.

Proposal

A deduction for charitable donations of property would be allowed for the lesser of the fair market value or the inflation-adjusted basis of the property. See Chapter 9.01 for a discussion of the indexation of capital assets. (In the case of a part sale/part gift, the amount of the charitable contribution deduction would be the portion of the inflation-adjusted basis of the property attributable to the gift portion of the transaction). As under current law, gain or loss would not be realized on charitable gifts.

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

For most income groups, charitable contributions are usually made in the form of cash, rather than property. For returns with adjusted gross incomes under \$100,000, less than ten percent of contributions constitute property. Only for incomes over \$200,000 does property account for as much as 40 percent of all contributions. Thus, the benefits of present law accrue to taxpayers with the highest marginal tax rates.

The proposal would eliminate the unwarranted tax advantages for donations of appreciated long-term capital gain property, as well as the complex rules limiting deductions for the various types of property that may be given to charity. In addition, the proposal would substantially eliminate the most serious opportunities for abuse through overvaluations of donated property.

The proposal also would eliminate the need for detailed valuations of contributed property in those cases in which the fair market value of the property clearly exceeds its adjusted basis. A determination of fair market value would still be needed for a part sale/part gift of appreciated property. Although valuations also would continue to be necessary for many gifts of depreciated property, taxpayers could ordinarily be expected, as under current law, to sell certain types of depreciated property and donate the proceeds of the sale in order to receive the benefit of any deductible loss. By significantly reducing the instances in which property valuations would be necessary, the proposal would ease the burden on taxpayers and the Internal Revenue Service caused by appraisal requirements.

The elimination of the current overly generous treatment of gifts of appreciated long-term capital gain property may have some adverse impact on the level of charitable giving. Some taxpayers, who are able to make gifts to charity at little or no after-tax cost under current law, may reduce their level of giving if current tax benefits are no longer available. The charitable contribution deduction, however, would still provide a significant incentive for charitable giving.

**REVISE PERCENTAGE LIMITATION
ON CHARITABLE CONTRIBUTION DEDUCTIONS**

General Explanation

Chapter 3.20

Current Law

The deduction for charitable contributions is subject to a variety of limitations based on the amount of the donor's income, the identity of the charitable donee and the character of the donation. For individual donors the charitable contribution deduction in any taxable year generally is limited to (a) 50 percent of the taxpayer's contribution base (defined as adjusted gross income before net operating loss carrybacks) for contributions to -- but not those for the use of -- certain organizations (generally public charities and private operating foundations), often referred to as "50 percent charities," or (b) the lesser of (i) the amount described in (a) that is unused and (ii) 20 percent of the taxpayer's contribution base for other charitable contributions (those for the use of 50 percent charities and those to or for the benefit of charities other than 50 percent charities). If, however, an individual contributes an appreciated capital asset that has been held for the long-term capital gain holding period, the deduction with respect to that property generally is limited (subject to the additional 50 percent and 20 percent limits) to 30 percent of the taxpayer's contribution base. This 30 percent limitation does not apply if the taxpayer elects to deduct only the adjusted basis, rather than the fair market value, of such property.

If an individual's contributions exceed the 50 percent limit or the 30 percent limit in any year, the excess ordinarily may be carried forward for five years. Excess contributions for the use of (but not to) 50 percent charities may not be carried forward. Excess contributions to 20 percent charities also may not be carried forward.

For corporations, the charitable contribution deduction is limited to ten percent of the corporation's taxable income, computed without regard to net operating or capital loss carrybacks. Amounts in excess of the ten percent limit may be carried forward for five years. Corporate contributions are deductible only if the gift is to be used within the United States.

Reasons for Change

The percentage limitations on charitable contribution deductions were imposed by the Tax Reform Act of 1969. At that time the after-tax cost of a charitable contribution could be extremely small for high income donors because of high marginal tax rates and because a deduction was allowed for the element of untaxed appreciation in certain types of donated property. The limitations on charitable

contributions were adopted in order to prevent wealthy donors from taking advantage of the favorable tax treatment of charitable donations substantially to eliminate their tax liabilities.

Since 1969, the top marginal tax rate has been reduced from 70 percent to 50 percent and would be further reduced to 35 percent under the Treasury Department proposals. In addition, the Treasury Department proposals would deny a charitable contribution deduction for the element of untaxed appreciation in donated property. Since those changes would increase the after-tax cost of charitable contributions, there would be no continuing need to limit the amounts of contributions for which donors receive deductions. Although a generous donor might still be able substantially to eliminate a particular year's tax liability through a large donation, the contribution would involve a proportionately large out-of-pocket cost to the donor.

Repeal of the percentage limitations for individual donors would also greatly simplify the tax treatment of charitable gifts. In addition, repeal would substantially eliminate the difficult questions arising under current law when an individual dedicates all or a substantial portion of his or her earnings to a charitable organization. Since income is generally taxed to the person who earns it, even if it is given away before it is earned, the percentage limitations may result in a tax liability for the individual on earnings dedicated to charity. This is a harsh result in a number of cases, such as where a member of a religious order donates his or her entire income to charity under a vow of poverty.

Proposal

The percentage limitations on gifts to or for the use of 50 percent charities would be repealed, together with the related carryover rules. (Carryovers from years prior to the effective date of the proposal would be allowed, subject to the percentage limitations under current law.) The current 20 percent limit on gifts by individuals to or for the use of charities other than 50 percent charities would be retained. In addition, contributions by corporations to or for the use of charitable organizations other than 50 percent charities would be limited to five percent of the corporation's taxable income, computed without regard to net operating or capital loss carrybacks. This five percent limit on gifts by corporations also would apply to contributions to any charitable organization that owns, directly or indirectly, more than one percent of the value or voting power of the donor corporation, or that is owned or controlled by persons who own or control the donor corporation. This limit is necessary to maintain the integrity of the feeder organization rules, which generally provide that a corporation shall not be exempt from tax merely because it pays all of its profits to a tax-exempt organization. (Section 502.) No carryovers of contributions in excess of these limits would be allowed. A provision

that in effect provides relief from the percentage limitation in the case of certain corporate contributions to the American Red Cross would be repealed as superfluous. (Section 114.)

Effective Date

The proposal would be effective for charitable contributions made in taxable years beginning on or after January 1, 1986.

Analysis

Although difficult to estimate precisely, it appears that fewer than 50,000 taxpayers (out of 100 million) would be affected by the proposal. Over one-half of the estimated revenue loss that would result from the proposal would be attributable to returns with AGI in excess of \$200,000.

REPEAL CHARITABLE CONTRIBUTION DEDUCTION FOR NONITEMIZERS

General Explanation

Chapter 3.21

Current Law

Contributions and gifts to or for the use of certain charitable and similar organizations are deductible, subject to certain limitations. Prior to 1981, a charitable contribution could be deducted only by individuals who itemized their deductions. The Economic Recovery Tax Act of 1981 (ERTA) extended the charitable contribution deduction to nonitemizing taxpayers, phased in over a five-year period. For contributions made in the 1984 tax year, individuals who do not itemize deductions are permitted to deduct 25 percent of the first \$300 of contributions made. For 1985 and 1986, the \$300 limitation is removed and the percentage of contributions deductible by nonitemizers is increased to 50 percent and 100 percent, respectively. Thus, under current law, the charitable contribution deduction will be allowed in full to nonitemizers in 1986. This provision, however, is scheduled to expire after 1986. After that time the charitable contribution deduction again will be limited to individuals who itemize their deductions.

Reasons for Change

Taxpayers are not subject to tax on their income up to the zero bracket amount (ZBA). This exemption is generally regarded as an allowance for certain personal expenses which ought not to be included in income and which all taxpayers are deemed to incur. In lieu of the ZBA, a taxpayer may itemize deductible personal expenses, such as certain medical expenses, interest expenses, and, prior to the ERTA changes, charitable contributions. Allowing a deduction for charitable contributions by nonitemizers in effect creates a double deduction for such contributions -- first through the ZBA, which is available only to nonitemizers, and second through the charitable deduction.

The allowance of a charitable contribution deduction for nonitemizers adds complexity to the tax law. These taxpayers must retain records of their gifts and go through additional computational steps in calculating their tax liability.

The charitable contribution deduction also creates serious enforcement problems. Nonitemizers generally make smaller charitable gifts than itemizers. A deduction may be claimed for numerous small gifts, made to a number of different organizations. It is extremely difficult and expensive for the Internal Revenue Service to monitor these deductions. Further, the cost of administration is

disproportionate to the amounts involved. These factors may prompt dishonest taxpayers to conclude that they can misrepresent their charitable gifts with impunity.

The charitable contribution deduction was extended to nonitemizers in order to stimulate charitable giving by such individuals. There is little data, however, indicating that the provision has had any significant effect on charitable giving by such individuals.

Proposal

The charitable contribution deduction for nonitemizers would be repealed.

Effective Date

The proposal would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

In 1982, 19 million returns, representing 31 percent of all nonitemizers, claimed \$431 million in charitable deductions. For 1983, preliminary statistics indicate that 23 million returns, 40 percent of all nonitemizers, claimed \$500 million in charitable deductions.

Although repeal of the charitable contribution deduction for nonitemizers may have some effect on charitable giving, any adverse impact is not expected to be significant. Nonitemizers generally have lower incomes and, thus, have lower marginal tax rates than itemizers. For this reason, tax incentives have less influence on nonitemizers. Moreover, since the deduction under current law is scheduled to expire in 1987, the proposal would have no impact on tax liabilities in years subsequent to 1987.

The proposal would simplify both the regular tax form (1040) and the short-form (1040A). The current deduction requires that a "worksheet" be included in the tax form instructions, on which the taxpayer makes calculations, the results of which are subsequently transferred onto Form 1040 or 1040A.